African Finance for the 21st Century
High-Level Seminar organized by the IMF Institute
in collaboration with the Joint Africa Institute
Tunis, Tunisia, March 4–5, 2008

Session I:
Setting the Stage

Finance in Africa: A Diagnosis

Patrick Honohan
Trinity College, Dublin

FINANCE IN AFRICA: A DIAGNOSIS

by **Patrick Honohan**[1]

Prepared for IMF Seminar "African Finance for the 21st Century",
Tunis March 4-5, 2008

After a decade of reforms African financial systems are diversifying their activities, deepening their lending, and increasing their reach with new products and new technologies. Financial repression and the practice of directed credit are both much diminished, and there has been extensive privatization of state-owned banks—often to foreign-owned banks, the re-entry of which represents only one aspect of a growing potential in internationalization and regionalization.

Yet financial development in Africa is still constrained by four pervasive challenges: a lack of scale, the informality of so much of African business activities, difficulties of governance, and the frequency and scale of shocks to the system. Although these are certainly present difficulties, they also represent opportunities in that much of the machinery of finance is specifically designed to repair, circumvent or cushion against problems of scale informality, governance and shocks.

Until recently there was a large gulf between the interests and views of financial policy specialists focusing on mainstream, formal sector, finance and those with an interest in informal and microfinance. But a growing awareness has emerged in the financial policy community worldwide that good development policy needs to pay attention to both aspects: "finance for growth" and "finance for all", that there is no significant conflict between policy designed to develop each of these aspects, and indeed that there can be a degree of convergence between the two (Caprio and Honohan, 2001, Demirgüç-Kunt et al., 2008).

In Africa, neither dimension is working well at present. Finance at the micro level is needed to get the bulk of the population (median income is still about a dollar a day in Africa) to the "bottom rung of the ladder", to use the image popularized by Jeffrey Sachs. Large scale finance – banking, securities markets, regional cooperation – is needed to make sure the ladder exists and is worth climbing.

Some of what is needed corresponds to what are by now highly conventional recommendations consistent with the essentially *modernist* approach of the Washington-based IFIs. However, not all that is conventional is good. African policymakers should, for example, beware of those who over-enthusiastically apply the modernist agenda by unthinkingly transplanting advanced economy regulatory models such as Basel 2 into an African environment where they could be not merely ineffective, but actually counterproductive and damaging. Likewise, regional cooperation in finance will only progress if a realistic prioritization is adopted—and in most cases the list likely shouldn't start with a common currency.

In contrast to some fundamentalists, I do not reject an *activist* perspective on financial sector policy, recognizing that Africa can present a somewhat unpromising prospect

---

[1] Trinity College, Dublin. This paper draws heavily on my 2007 book with Thorsten Beck

to some market participants and may need the push of committed people of good will. For example, I believe there is room and need for many more providers of financial services to small and microenterprises and poor and near-poor households. Microfinance is currently provided in Africa by a myriad of different types of institution and I believe that this diversity should be encouraged, given that nobody has the monopoly of wisdom on what can work in the difficult environment that is Africa, hampered by small scale, informality, inadequate governance and repeated major shocks.

We begin (Section 1) by documenting the key facts about African financial systems, before looking in turn at the policies needed to ensure that the financial services needed to lubricate and accelerate African growth are provided at sufficient scale and with sufficient efficiency (Section 2). We then turn to finance at the small scale, asking how policy can help ensure that financial systems have sufficient outreach (Section 3). Concluding remarks are in Section 4.

1. Facts

For money doctors, Africa is, or should be, a priority. Mapping the responses of surveyed entrepreneurs around the world to questions about what they see as the main obstacles to their firm's business operation and growth, we find[2] that African entrepreneurs identify the cost of finance as an obstacle more frequently than those of any other regions. The same is true for access to finance. In both cases – cost and access – the next closest region is unsurprisingly Latin America, a region notorious for its history of financial crises and crippling nominal interest rates. Most outsiders express surprise at the fact that Africa tops the list here. After all, given the low level of infrastructure, the weaknesses in health and education and the troubled political and security history of Africa, one might well suppose that other considerations would loom larger as obstacles to African business people. Yet, of eighteen different types of problem, cost of finance is the most frequently mentioned obstacle mentioned by African entrepreneurs. So, not only is Africa the region in which finance looms largest, but in Africa finance is the number one barrier.

Turning from perceptions to objective indicators of financial sector development, it's not hard to find evidence that Africa' s financial systems are indeed an area of weakness. Using the size of the banking system, whether measured by total monetary liabilities or by the volume of bank credit outstanding, Africa's systems are small in a global comparison. That is especially evident if we simply look at absolute size: only South Africa and Nigeria are above the World median. Absolute size does matter for achieving economies of scale,[3] though it is evident that the small absolute size of the typical African financial system is largely a reflection of the small size of the economies. Still, scaling these measures by GDP reveals that the banking systems in African countries are not only small, but shallow. Indeed, although four African countries make it above the global median of monetary depth, three of them do so because they are offshore centers – Mauritius, Seychelles and Cape Verde (Figure 1).

[2] The data underlying the assertions in this section are presented more fully in Honohan and Beck (2007), from which the figures are also drawn. The Fund's Regional Economic Outlook series, 2006 and 2007 contain additional analytical data.

[3] For example, the fact that mean operating (administrative) costs of African banks is almost 2 percentage points above the world mean may owe much to lack of scale economies (Honohan and Beck, 2007, p. 36; see also Bossone et al., 2002).

So it's not just because the economies are small that they have small financial systems. The shallowness is correlated with *per capita income*, yet even after taking account of this (and also of the cross-country variation attributable to persistent inflation lowering money demand) more African countries fall below the line than above it (Figure 2—though the wide cross-country variation means that this may not be a statistically significant difference).

One important reason why there is less money held "onshore" in African banks is that so much is held "offshore". Data collected by the BIS on the nationality of deposit-holders at banks in advanced economies reveals that African offshore deposits represent a high proportion of the onshore deposits in their countries – over 100 per cent in one case and typically in the region of 25-60 per cent. These are much higher percentages that reported for any other region (Figure 3), and point to an exceptional lack of confidence among African liquid asset holders, corporate and individual.

But there is a deepening in progress and it is not just a question of the last few years or of the oil-producing countries. Median banking depth, whether measured by deposits or credit as a percentage of GDP, bottomed out in 1996, and has been rising steadily ever since. Four out of every five countries has seen deepening since 2000. An important point to which we will return is the fact that the deepening has been more pronounced for deposits than for private credit. This reflects the growing pattern whereby African banks place a much lower proportion of their resources with private sector borrowers than do banks in other regions (Figure 4); instead their claims on government and on state-owned enterprises are much higher than in any other region, and only the Middle-East and North Africa banking systems place a higher proportion in foreign assets. While crowding-out by government is part of the story, bankers' risk aversion is here also a factor to which we will return.

While banking depth is a convenient general purpose indicator of financial development, it doesn't capture all of the relevant components. It's important in particular not to neglect issues of efficiency and of the non-bank financial sector. Interest rate levels and spreads can throw light on the efficiency of banking, and the story they tell is broadly in line with the message from data on depth. It's not just a question of overall interest rate levels; these are largely determined by macroeconomic considerations including inflation expectations, as well as by the degree of financial repression. The liberalizations of the late 1980s and 1990s largely removed the repression that had kept real interest rates negative, and rates bounced-up to heights that compensated financiers for the perceived risks in holding assets denominated in local currencies. There was probably an overshoot, especially on bank lending rates, with median real lending rates soaring to above 20 per cent by 2001, and the subsequent decline may have been associated with some more increase in competition associated with liberalized bank entry. The competitive situation in African banking cannot, however be considered vigorous. Net interest margins in African financial systems are higher than in any other region of the world – albeit not much worse than Latin America. Part of this can be attributed to the insecurity of property rights, part to insufficient scale, part to higher historic inflation, but after adjusting for these and other bank-specific factors, we still find an unexplained average 60 basis point excess in African bank margins. Insufficient competition is a likely culprit. Banks in Africa returned an average of 2.1 per cent on assets during 2000-4, compared with a world average of 0.6 per cent. Of course, banks are a heterogeneous collection of diverse entities, but even more tellingly, taking the subsample of international banks with operations in Africa and in other parts of the world, an even larger difference emerges: 2.8 per cent in Africa compared with 0.9 per cent elsewhere.

Not that foreign entry has been systematically blocked. Far from it. The foreign banks are back to a greater extent than elsewhere. Characterizing the ownership of banking systems around by whether they are dominated by banks owned by foreigners, by the state, or by non-state nationals, we find that about half of African banking systems are mainly foreign-owned, with just a handful mainly government-owned. The degree of foreign ownership is much higher – and of government ownership much lower – in Africa than in other regions of the world. The foreign banks are a diverse lot. They vary from the traditional European-owned banks – some of the biggest of which trace their African business back more than a century – to a new breed of multi-country banks headquartered in Africa. Though there have been false starts before, this emergence of truly African-based regional banks, which is being accelerated by the huge regulated increase in bank capital in Nigeria, is to me a most promising development.

The ability of the Nigerian equity market to raise almost USD 3 billion in new bank capital during 2003-5 also points to a somewhat unexpected resilience of African equity markets. Of course most of them are very small and many cannot cover their operating costs or the costs of regulating them, but a quantitative assessment (based on data collected in World Bank, 2006) along dimensions of efficiency, stability, access as well as size show African stockmarkets – even excluding Johannesburg – to be not far behind the average of developing countries except on the dimension of pricing efficiency (see Yartey and Adjasi for a discussion of the role of African stock exchanges in contributing to growth). Even if little new money has been raised on these markets by the vast majority of the listed firms, their presence on the exchange and even modest local holdings can provide a degree of political protection for enterprise and involve African elites in the development of the private sector more widely.

2. Finance for Growth

What cross-country studies have shown rather consistently is a causal impact of deep financial systems on national growth. Finance seems to represent one of the crucial institutions needed to underpin sustained growth. (And there is no compromise here with inequality: contrary to what one might suppose from the degree to which the direct dealings of mainstream finance are mainly with higher income groups and formal sector enterprises, a finance-intensive growth pattern is associated across countries with *less* inequality, not more.) The key dimension here seems to be credit to the private sector and as we have just seen, it is in this dimension that African banking systems are weakest both in terms of cost and volume.

The unwillingness of African banks to lend even the limited resources they are able to mobilize likely reflects their perception of risk. Evidence in support of this comes from the clear cross-country negative correlation between (a) the share of banks' resources held in liquid form (and thus not lent out) and (b) the ratio of bank deposits to GDP (Figure 5). In other words, it is in the countries where depositors are most reluctant to entrust their savings to the banks that banks are most reluctant to entrust their resources to local borrowers. Building the confidence of both is a clear priority for improving the functioning of financial systems.

There is a well-defined modernist agenda for making progress here. For the most part it involves adopting and importing mechanisms that work in advance economies. Yet the modernists sometimes go too far and attempt inappropriate and unwise transplantation.

For instance, the modernist agenda seeks:

– to make bank lending easier and safer for banks by

(i) Working on information infrastructures as well as legal and judicial ones. This includes for example the creation or improvement of credit registries allowing (and indeed obliging) lenders to pool information about their borrowing customers' credit history. It includes refinements to the law on secured lending for example where additional protections are needed for leasing or lending warehouse receipts. It can require improvements in the administration of the courts.

(ii) Pruning unnecessary regulations. As much as an adequate and incentive-compatible regime of prudential regulation and supervision is essential if the banking system of any country is to be protected against damaging systemic collapses into insolvency, it does not follow that all and any prudential regulations are productive or needed. There are still a number of outdated and regulations in place that unduly constrain African lenders, though probably fewer than the banks themselves believe

But modernists are also pushing for the introduction of the Basel 2 regulatory system in African countries. While the bank risk management systems that are promoted by Basel 2 have much to recommend them, it is quite a different matter to base one's regulatory system on premature adoption of what will, for the foreseeable future in the African context, inevitably be unproved and largely unverifiable systems. Supervisors will be put on the defensive if they try to restrain risky practices adopted by a bank which has calibrated its internal ratings systems (based on purchased software) is such a way as to make the practices seem safe. As for the alternative "standardized" version of Basel 2, which bases required capital on independent borrower ratings, this is a wholly incredible approach for low income economies with no existing rating industry and no credible incentive mechanism for ensuring reliable ratings (Quintyn and Taylor, 2007, discusses regulatory structures for banking in Africa).

The modernist agenda also seeks to improve the environment for long-term and risk finance by

(i) Building on the growing investable funds of pension and social security funds, including by removing unduly constraining portfolio allocation restrictions, and replacing with enhanced mechanisms of governance and transparency (for instance putting the reporting mechanisms of the stock market to good effect)

(ii) Putting in place administrative, tax and other arrangements that are needed to underpin the emergence of a sizable mortgage finance market and new risk-sharing mechanisms of infrastructure financing.

But again the modernists can over-reach. The tendency, in particular, to adopt the full panoply of investor protections in securities markets may have resulted in entry costs that deterred many would-be issuers. A lighter and more pragmatic form of capital market regulation, for example using the AIM approach of the London market, which relies to a somewhat greater extent on *caveat emptor* which retaining considerable disclosure, could open the door to more listings and more capital being raised from the institutional and wealthy investors that already predominate in African markets

When it comes to macroeconomic and fiscal stability (including predictable government debt management), there can be no disagreement with the main thrust of the modernist agenda, which seeks to build a firm overall macro platform on which financial intermediation can be built. Yet even here the modernists can get carried away. As recent IMF studies have suggested (cf. Adam et al., 2007) monetary management in an environment of growing inflows, fairly common across the continent in recent years, whether due to oil price rises or increasing aid, becomes quite tricky. The growing inflows swell the money supply, prompting a contractionary reflex by mechanical monetarists; but this may prove to be the wrong reaction if demand for money is also growing as a result of the favourable external conditions. After all, avoiding overvalued exchange rates is one of the key requirements for sustained growth in Africa as has been pointed out by Johnson et al. (2007).

Finally, there is a modernist agenda on regional arrangements. Indeed, regional cooperation has been advocated for African states by external advisors for a century and a half. But a pragmatic approach to sequencing of regional cooperation in finance is needed to avoid the risks and disappointments inherent in a no-holds-barred modernist attempt to leap to a single currency in the image of Europe. Instead, regional cooperation should concentrate on high yield, feasible dimensions. These could include deeper cooperation in banking supervision, including cross-country sharing of supervisory responsibility as has already been put in place in the two francophone zones. Attempts to gain economies of scale from one or other of the possible hub-and-spoke models of securities market organization could be another example of a worthwhile and low-risk form of regional cooperation.

3. Finance for All

Fewer than one in five African adults have access to a formal or semi-formal financial intermediary. This striking if not very surprising statistic is again partly a reflection of the low income levels and infrastructure weaknesses across the continent – indeed, while lower than other regions, these household access percentages are not as far below the rest of the world as are the financial depth measures described above.

Aspects of the four underlying challenges mentioned above make direct access to financial services particularly problematic in large parts of Africa. This is evident where population is sparse, incomes low, infrastructure weak. There are some things that can be done by modern technology, both physical and financial. Mobile phones and the internet are already overcoming isolation and costly teller services in several parts of Africa. Weather and price insurance programs for farmers have been piloted with some success. And there are a few age-old techniques that mainstream banks have not until recently bothered to introduce in Africa and which could improve credit availability especially for the farm sector.

While the employment of new technology has thus been shown to offer considerable potential for improving outreach in Africa, it is not going to be enough. Certainly, the mainstream banks have not delivered long term or risk finance; or any services for the majority.

Therefore, if it is the modernists that mainly set the agenda when it comes to improving "finance for growth", the many evident shortcomings of mainstream financial systems even in advanced countries for delivering services directly to the poor or marginalized means that anybody concerned with improvements here is likely to be an activist.

If there is to be the needed progress in outreach, there will have to be new (or re-engineered) entrants with a dedicated mission. They will need to be patient, to take risks, and to experiment with new technology. In particular they have to make better use of soft information and relationship lending, which have been rather neglected in the modernization of automation of modern banking.

There will also have to be a policy response, for which an interesting model is found in the South African financial sector charter of 2003 and subsequent developments.

However, effective activism in finance presupposes good governance. Activists are not restrained by immediate market pressures; they have chosen to plough money and effort into endeavours that the market has turned down. Hidden among the patient and motivated idealists can be rogues and opportunists who are difficult to detect. To be even reasonably confident that these efforts and resources will not be wasted or subverted, the sponsoring agency of financial activism must have good governance.

The disappointing experience of state-owned DFIs across much of Africa is testimony to the importance of these cautionary remarks about activism. Indeed, because of this experience, it seems clear that government-run DFIs will rarely be the optimal solution. If state-owned financial firms are present, at the very least it is essential that they should be operating with as level a playing field as possible, and under good governance procedures. The mandate and business of state-owned firms should be designed to limit their exposure to downside risk. This argues for service provision rather than risk assumption. In the case of state-owned guarantee funds – seemingly the intervention of choice today for numerous financial activists – it argues great attention to incentive structures built into the risk-sharing element of the guarantee programs (cf. Demirgüç-Kunt et al., 2008, pp 168-175).

So if there are to be activists, one has to be careful about who does what. Numerous different players will need to be involved in the effort to make finance work for Africa. There are messages here for all the players. Regulators should be flexible in admitting a wide range of institutions, building on what is already a very diverse population of financial service providers across the continent.[4] Mainstream banks will need to play a role, though this is likely to be mainly as wholesalers until and unless they can get costs down and improve relationship lending

Donors and development partners can contribute a lot in helping promote greater access in the form of resources, of innovation, of independence (where they might partly compensate for local governance gaps). Finally, the message for governments is that, while they should probably try to stay as far away from ownership of financial firms as they can, nevertheless they should be actively creating infrastructures and ensuring that they are not choking innovation with over-regulation.[5]

4. Concluding remarks

Better financial systems with a wider reach represent a key ingredient in getting African economies onto a sustainable growth path. By providing an alternative to government patronage as the a basis for entry into business, a strong, independent financial system can transform the business environment for enterprise.

There are echoes here of the recent paper by Nobel prize winner Douglas North and his co-authors (2006) who claim that the key difference in history between economies that have achieved rapid and sustained growth and those which have languished is the difference between open access and closed access societies. This is a political as well as an economic concept, and access to finance is only one ingredient in transforming your society into an open access society, but it is a necessary ingredient. Besides, if the elite truly set about creating the conditions for financial access, then the rest will fall into place.

African elites, responding rationally to the recurrent cycle of national social, political and economic meltdowns, have looked to extracting their slice of a transitory pie instead of looking towards what would be a smaller slice of a bigger pie if they were prepared to build for the long term. A financial system which allows elites to participate more effectively in the fruits of a broad-based sustained economic growth could help shift their incentives, opening up a new vista for the continent.

Bibliography

Adam, Christopher, Stephen A. O'Connell, Edward F. Buffie, Edward F and Catherine A. Pattillo. 2007. “Monetary Policy Rules for Managing Aid Surges in Africa.” IMF Working Paper No. 07/180

Bossone, Biagio, Patrick Honohan and Millard Long. 2002. “Policy for Small Financial Systems.” in Gerard Caprio, Patrick Honohan and Dimitri Vittas, eds., *Financial Sector Policy in Developing Countries* (Washington, DC: The World Bank).

---

[4] For example, the unproven and constraining idea that only cooperative entities, or alternatively only corporate entities, can work well in delivering microfinance should not be embodied in legislation.
[5] Not least in overzealous and poorly designed AML regulation and its potential strangling effect on microfinance (Isern et al., 2006)

Caprio, Gerard and Patrick Honohan. 2001. *Finance for Growth: Policy Choices for a Volatile World* (New York: Oxford University Press).

Demirgüç-Kunt, Asli, Thorsten Beck and Patrick Honohan. 2008. *Finance for All: Policies and Pitfalls in Expanding Access* (Washington, DC: The World Bank)

Honohan, Patrick and Thorsten Beck. 2007. *Making Finance Work for Africa* (Washington, DC: The World Bank).

IMF. 2006, 2007. *Regional Economic Outlook: Africa* (Washington, DC)

Isern, Jennifer, David Porteous, Raul Hernandez-Coss and Chinyere Egwuagu, C. 2006. "AML-CFT Regulation: Implications for Financial Service Providers That Serve Low-income People. CGAP Focus Note 29. Washington, DC: World Bank.

Johnson, Simon, Jonathan Ostry and Arvind Subramanian. 2007. "The Prospects for Sustained Growth in Africa: Benchmarking the Constraints." IMF Working Paper No. 07/52.

North, Douglass C. John Joseph Wallis and Barry R. Weingast. 2006. "A Conceptual Framework for Interpreting Recorded Human History." NBER Working Paper 12795.

Quintyn, Marc and Michael W. Taylor. 2007. " Building Supervisory Structures in Sub-Saharan Africa – An Analytical Framework." ." IMF Working Paper No. 07/18.

Sachs, Jeffrey D. 2005. *The End of Poverty: Economic Opportunities for Our Time* (New York: Penguin)

World Bank. 2006. "Equity Market Indicators: A Primer." Financial Sector Indicators Note 3. Washington DC: The World Bank.

Yartey, Charles Amo and Charles Komla Adjasi. 2007. "Stock Market Development in
Sub-Saharan Africa: Critical Issues and Challenges." IMF Working Paper 07/209

Figures

Figure 1: *Financial depth (Liquid liabilities as % GDP): African countries shaded.*

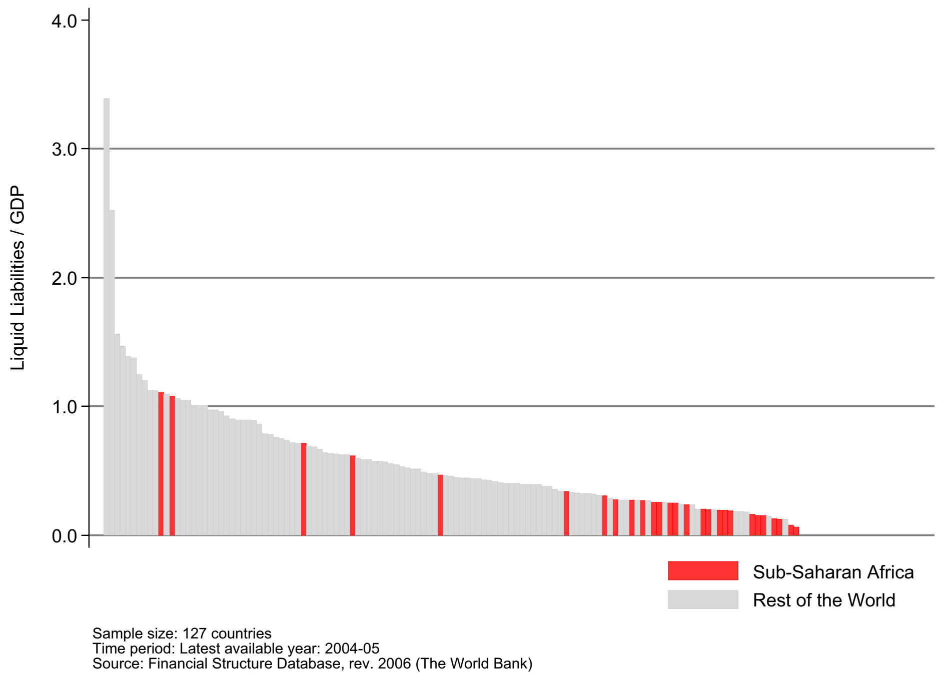

Figure 2: *Financial depth (Private credit as % GDP) versus GDP per capita.*

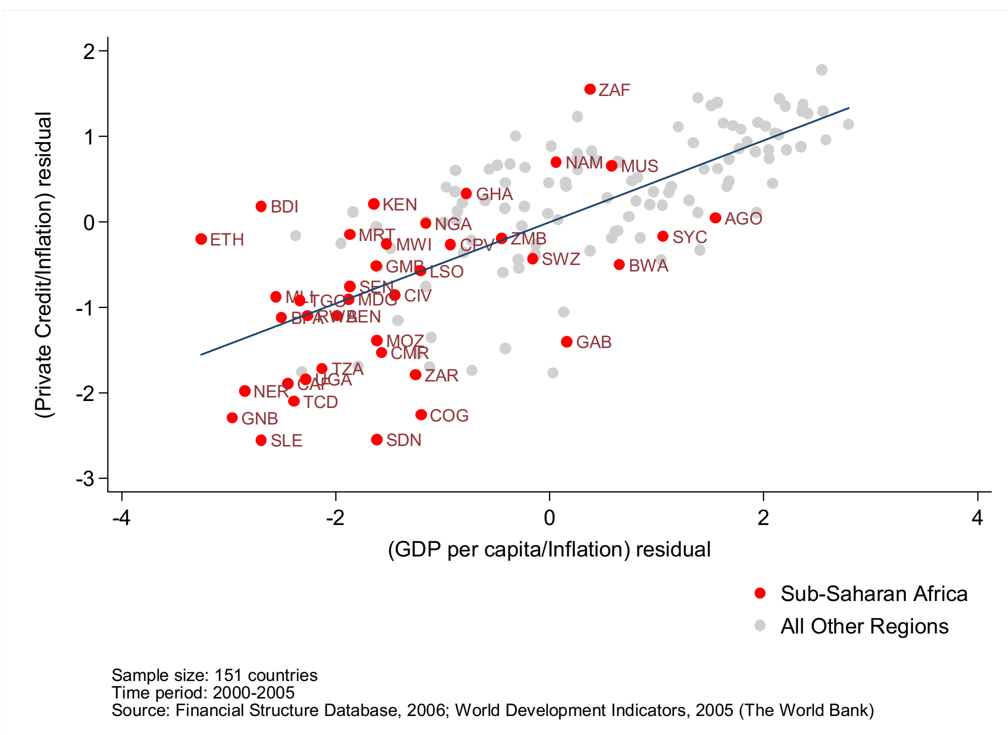

Figure 3: *Òffshore bank deposits divided by domestic bank deposits in different regions*

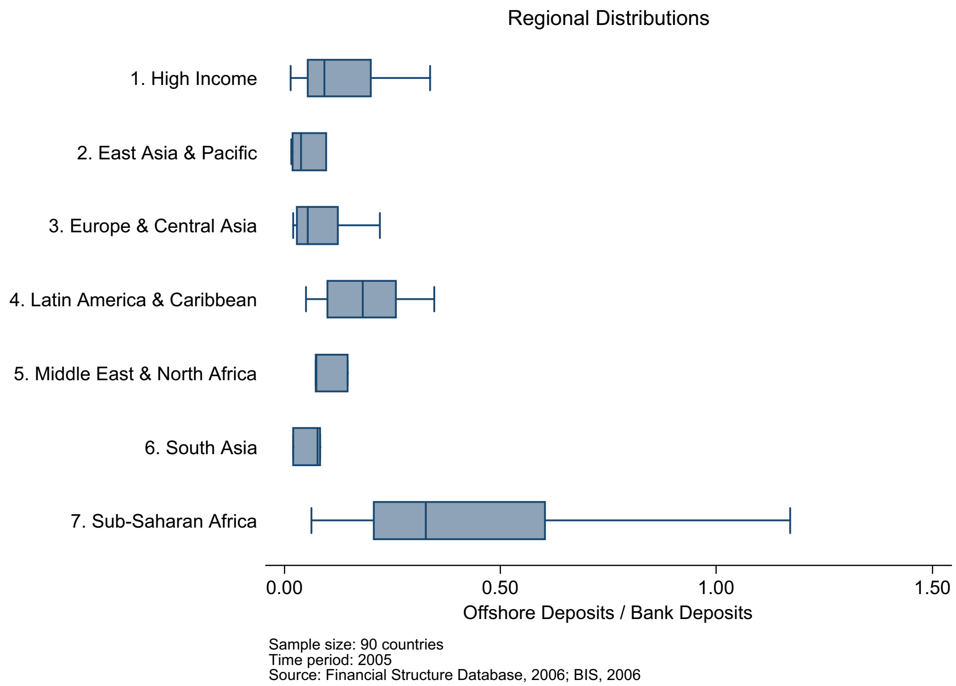

Figure 4: *Composition of bank assets in different regions*

Figure 5: *African banks: financial depth and liquidity*